“The Empty Playing Field”

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Testimony Before Hearing on “Fair Disclosure or Flawed Disclosure: Is Reg FD helping or hurting investors?”

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On Aug. 10, 2000, the Securities and Exchange Commission approved Regulation FD, for "Fair Disclosure," which required firms to release "material" information about their business to everyone if they release it to anyone. The regulation became effective two and a half months later. While the purpose of Reg FD was to help small investors, it has actually hurt them. Since the regulation was enacted, the volatility of markets has increased – making them scarier places for the public and increasing the cost of capital for corporations. The regulation appears to have led to less disclosure of information by companies, and it has certainly led to a lower quality of information emanating both from those companies and from the analysts who cover them. Again, the result has been to hurt the investing public, the prospective beneficiary of the regulation.

As the SEC prepared to vote last summer on the new regulation, the general counsel of the Securities Industry Association, Stuart Kaswell quipped, "The playing field will be more level" if Reg FD is approved, "but it will be empty."

While I do not always agree with the SIA, Mr. Kaswell's comment turned out to be prescient -- only a slight exaggeration. Reg FD is not just unnecessary. It has proven counterproductive.

Were the adverse consequences – the increased volatility and the decreased information and analysis -- unintended? That's hard to believe. Warnings abounded before the Reg FD was approved and even advocates admitted that higher volatility was a likely result. For example, in an op-ed piece in The New York Times shortly before approval of the regulation, Daniel Gross, author of the book *Bull Run* and a supporter of the rule, admitted the obvious: Reg FD "will surely bring greater volatility."

Then, did the SEC believe that adverse consequences were simply the price that had to be paid to achieve more important objectives: “fairness” through the elimination of special advantages enjoyed by analysts and professional investors and “objectivity” through the elimination of a system that could reward analysts with access if they gave favorable reports?

That seems likely. My own view, however, is that high volatility and degraded information quality have been far too high a price for small investors to pay for a particular vision of fairness.

I speak as someone who has devoted much of his professional life to educating small investors and advocating policies to help them. For nearly 20 years, I have been writing about finance and economics while, in recent years, also serving as a resident fellow at the American Enterprise Institute for Public Policy Research in Washington, D.C., and hosting a website that focuses on the nexus among technology, public policy and finance. From 1993 through 1999, I wrote an internationally syndicated twice-weekly investing column for the Washington Post. I then became the first investment columnist in the history of Reader’s Digest, the largest-circulation magazine in the world. I am co-author of a book, *Dow 36,000*, which examines stock valuation, and I currently write regular investing columns for the International Herald Tribune; the New York Daily News; www.foliofn.com; and my own website, www.TechCentralStation.com. I am currently writing a primer for small investors that will be published by Crown Books early next year. In all these efforts, my aim has been to inform small investors, many of whom have been thrust into the market with little preparation. My strong belief is that, for most

Americans, the stock market is the only route to the kind of wealth necessary for a comfortable retirement, so understanding the market and investing wisely is not a luxury but a necessity.

I have generally applauded the work of the SEC during the tenure of chairman Arthur Levitt Jr. Mr. Levitt was my business partner from 1998 to 1993, when we were owners together of Roll Call, the Congressional newspaper that I edited. The concern of Mr. Levitt and his fellow commissioners for small investors was important during the 1990s, a period of turbulent markets and the entry of tens of millions of new investors. But, at times, the commission's appropriate concern has led to inappropriate policy – mainly because of a lack of faith in the free markets and the competitive process. Reg FD is a prime example of a top-down regulatory policy that disrupts an often-messy process which, ironically, produces better results for small investors.

Is it fair that corporate executives share information with some analysts and not others – or with some analysts and not the public at large? Fairness is a word whose meaning can only be personal, not precise. Is it fair that elected officials, including many members of Congress here today and certainly even commissioners of the SEC, share information with selected journalists and not others – or with some journalists and not the public at large? That would seem to be even *less* fair than selective sharing by corporate executives since public officials, by definition, serve the public. Yet selective sharing by politicians happens every day and undoubtedly works not only to promote good policy but also to promote the financial well-being of journalists and their publications. (The journalists' stature and perhaps salary are enhanced, and the publication sells more copies.)

Certainly, selective sharing of information by politicians is a way to put more information into circulation. Without that sharing, the information might not come out at all, or might not be understood.

The vague concept of fairness must be balanced against a concept more substantial – that of encouraging the dissemination of as much information and analysis as possible (and of as high a quality as possible) so that investors can make decisions related to securities ownership. If a fairness regime inhibits the flow of information and analysis, then it may be counterproductive. That is the case with Reg FD.

Just a simple example. Companies now regularly broadcast conference calls not only to analysts but also to the general public, which tunes in through the Internet. This kind of general sharing of information is fine. But, in the past, when analysts had questions about the conference call, they would themselves call up and ask company officials after the call was over. Those officials would often provide needed guidance. With Reg FD, they no longer do so. In the end, it is the public that is hurt by this reduced information.

What is the best way to encourage the dissemination of information? Not government rules, but open competition. Competition, driven by consumer choice, is the key to abundance and variety in the marketplace both of goods and services and of ideas. Analysts compete. They work to get information about corporations because that information – plus subsequent judgments they draw from it – gives them an edge over other analysts. As my colleague Kevin Hassett, an economist at the American Enterprise Institute, has written: “Analysts do this hard work because they (or their firms’ clients) will profit if they are a little bit smarter than the next guy.” It is the potentially asymmetrical nature of the distribution of information that triggers the competition from which, in fact, all investors benefit – whether they are clients of the analyst with the initial edge or not.

If information, by law, is relayed to all analysts – and, in fact, to all citizens – at the same time and in the same way, then the incentive for hard work by analysts declines sharply. Less information comes out. And small investors suffer.

While the Internet offers the technology to make vast amounts of information about companies available to investors, the role of analysts remains critical. Raw numbers don’t help most investors, who have a hard time telling an income statement from a balance sheet. More than ever, they need analysts to analyze, to tell them what the numbers mean – and to ask corporate managers to find out. While analysts sometimes make mistakes, their efficacy has been established in academic research, including a key paper by Keane and Runkle (American Economic Review, Sept. 1990, pp. 714-35) titled, “Testing the Rationality of Price Forecasts.”

In addition, according to several surveys, Reg FD has led skittish companies simply to disclose less information. For example, at an Institutional Investor roundtable for the heads of major mutual funds, an on-site survey found that 88 percent agreed or strongly agreed that Reg FD has been a “chill” on the flow of information from companies. And 82 percent said companies today provide less information than they did before the regulation.

On the very day last year that Reg FD officially went into effect, *The Wall Street Journal* ran an article about Matthew Berler, a Morgan Stanley Dean Witter analyst, who tried to ask a Georgia-Pacific executive for the usual guidance with Berler's spreadsheets, which cover 887 financial factors regarding the company. This time, though, he got no help from Georgia-Pacific, which was worried about violating Reg FD. As a result, says Berler, "there's a greater chance of error." (A study by the Securities Industry Association has since shown that 93 percent of analysts have noted a decline in issuer reviews of their reports.) Also on the day FD was launched, *The Washington Pos*t reported that the chief financial officer of TeleCommunication Systems, Inc., on advice of his lawyer, would not answer the questions of an influential Wall Street tech analyst.

But the object of the rule is not to help analysts. It is to help investors.

What is Reg FD giving investors? Less information, not more. As a result, the market is displaying more volatility, not less – since firms, even though they know what is happening in their own businesses, can't tell anyone unless they everyone. Frankly, we have enough volatility. Another word for "risk," volatility is the bane of every investor's existence. Higher volatility ultimately means lower stock prices since it raises the cost of capital and scares investors from the market.

Mr. Gross, in his New York Times article, argued that, despite higher volatility, the rule is a good one since "analysts seeking an edge will actually have to do some reporting and make gutsy calls." We can't argue with that. Many analysts are, indeed, lazy – or, worse, they are merely shills for the companies they cover or patsies for their own firms, which often sell their investment banking services, at a nice profit, to the same companies their analysts praise.

But Reg FD, first of all, exacerbates the laziness problem since it discourages analysts from competing for fresh information, and it does nothing to help solve the coziness problem. Instead, it creates a completely new problem – an information bottleneck that squeezes the life out of the battle for information. In the past, an analyst may have gained a slight edge if a company leaked her some information, but that information quickly got circulated in this Internet age, and, within a very short time, it was available to all investors.

Instead, today, with information limited by Reg FD, investors have often been shocked, for example, by quarterly earnings results about which they may have learned, in a more gradual, less abrupt way, in preceding months. These shocks have almost certainly led to increased volatility, and high volatility leads small investors, especially, to make poor decisions about the stocks they hold and may acquire.

Also, press releases and earnings announcements present information in a less contextual manner in a post-FD world. As Frank Fernandez, chief economist for the Securities Industry Association, wrote in an article in SIA's Research Reports on April 30: "Additional content and analysis that used to accompany the release in the pre-FD environment…often functioned as a filtering mechanism and included the provision of financial advice to investors on how to respond to the arrival of this information. The release [now] produces an immediate price impact, which is amplified by the greater uncertainty generated by the absence of context and additional content and the provision of analysis and advice."

Perhaps the quantity of information reaching the public has increased under Reg FD. Even so, the quality has declined. While I am a strong advocate for small investors, I agree with Louis M. Thompson Jr., president of the National Investor Relations Institute, who wrote in the Investor Relations Quarterly:

"Although the Internet is having a significant impact on disintermediation of the securities markets, analysts and professional investors still have an important role in the investment process. It takes a huge leap of faith to believe that most individual investors can take all the raw information to which they now have access and make sound investment decisions, particularly in a down market. Moreover, more than half of America's families invest, directly or indirectly, in mutual funds and rely on their portfolio managers to have access to quality information. Under Regulation FD, that is no longer the case."

Very simply, a more abundant flow of information dampens volatility. That was one of the great hopes for the Internet, and it was on its way to fruition before Reg FD.

Do we know for certain that Reg FD has increased volatility? Surveys of investment professionals indicate that it has, but, clearly, it is impossible, at this early stage, to separate the contribution to volatility made by the Reg FD and the contribution of other factors. Still, it certainly stands to reason.

What should be done about Reg FD? Don't fix it, as many issuers and securities industry officials have argued. Abolish it. Regulation FD is simply the latest manifestation of an approach to regulation that is harmful to consumers because it denies them the benefit of free-market competition. Just as companies compete for the favor of customers, they will – given the chance – compete for the favor of investment analysts, their clients and investors at large. How? In part by trying to gain an edge on competitors by offering what analysts and investors want most – information. A company that can be relied upon for timely, abundant and thorough business data, placed in truthful context, is a company that will attract more capital – all else being equal. Investors don't like businesses to keep them in the dark.

What is the best way for such information to bloom? Free competition – not government rules. Regulations set both and floor and a ceiling on disclosure. They give businesses an excuse for not telling more. But Reg FD is even worse than typical disclosure regulations. Reg FD actually encourages businesses to tell less.

Imagine a securities regulator that simply policed fraud and insider trading. In the absence of regulations, would corporations still report earnings quarterly? Of course. (See an examination of the case of Germany in Cummins, Harris and Hassett in *The Effects of Taxation on Multinational Corporations*, p. 187, National Bureau of Economic Research, 1995.)

Some firms might do so even more frequently. Any firm that tried to hide its performance would lose investors; its stock price would drop, raising capital in the public markets would become more difficult.

What Reg FD reveals is a misguided, often destructive regulatory mentality – the hubristic notion that regulators stand between investors and chaos. That is simply untrue. Orderly markets in goods and services flourish without the heavy hand of regulation about disclosure (imagine if a car company could not talk with researchers from Consumer Reports without issuing a press release). Markets in financial information – given half a chance – will do the same.

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